

‘Some Lessons for Monetary Policy from the Recent Financial Turmoil’

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The present financial crisis has many parents, encompassing both market failures and supervisory shortcomings. A non-exhaustive list would include: inadequate incentives for care in the origination of loans if the risks are to be passed on; extreme opacity in the nature of the risks underlying complex structured finance assets; too much reliance on statistical models of risk based on past behaviour; disproportionate dependence on ratings by end-investors and a failure to observe due diligence; excessive closeness of the ratings agencies to those who were issuing debt; compensation schemes in financial institutions that encouraged excessive risk-taking and a focus on short-term returns; a failure by originating banks to realise the extent to which distributed risks could return to them; excessive reliance on short-term wholesale funding and inadequate attention to the potential liquidity of assets; and a failure by regulatory and supervisory authorities to appreciate fully the risks inherent in the 'originate-to-distribute' model. The ongoing work of the Financial Stability Forum and G20 to address these and related issues and to strengthen the financial system against any future repeat is, of course, extremely welcome.

But these are just the collective match that ignited the conflagration. You need fuel to make a fire too. And that was provided by the *ex-ante* excess supply of global savings over investment, which pushed real interest rates on safe assets to historically low levels, reinforced by loose monetary policy. That in turn encouraged a 'search for yield' and a compression of risk premia as financial institutions sought returns high enough to meet end-investors' unchanged expectations. Moreover, higher asset prices raised the net worth of financial companies, allowing more borrowing and further compressing yields.

This 'savings glut', as Chairman Ben Bernanke christened it, was in part the result of high national savings rates in some Asian emerging economies, especially China, which despite high investment rates, chose to export capital rather than import it, as standard theory would lead one to expect. High savings rates in Japan for demographic reasons and, latterly, also by some of the major oil producers further

boosted the supply of global savings. One factor behind the high level of savings by the emerging market economies was their experience during the 1997-8 Asia crisis, when several countries were forced to tighten policy sharply in the face of a 'sudden stop' of capital inflows from abroad. Thereafter, a strategy of relying on domestic savings to finance investment and the accumulation of a substantial war chest of foreign reserves looked more appealing. Another was the lack of an adequate social welfare net that encouraged high levels of precautionary savings by households.

On top of this, global monetary conditions were relatively easy for much of the past decade. In the United States, monetary policy was relaxed aggressively during the ICT-led downturn that started in 2001. With growing concerns about the possibility of deflation, policy was deliberately kept loose until mid-2004, even though the economy had begun to recover earlier. For instance, John Taylor<sup>1</sup> has calculated that applying his eponymous Taylor Rule in mid-2004 would have pointed to a Federal Funds rate as much as 300 basis points higher. And even once the monetary stimulus was withdrawn, it was carried out at a 'measured pace'.

Because a number of countries, most obviously China, chose to peg their currencies either to the dollar or to a basket in which the dollar featured heavily, the FOMC had to cut rates more aggressively to maintain domestic activity than would have been the case if the dollar had been free to depreciate against them. Moreover, by virtue of the currency pegs, this monetary looseness in the United States was transmitted overseas, despite attempts at sterilisation. Now the primary driver behind the surge in commodity prices over the past three years or so has been the rapid development of the emerging market economies and the consequent growth in commodity demand running up against relatively inelastic supply. But the general pickup in inflation worldwide, together with the appreciation of a range of asset prices, suggests that accommodative monetary policies may have also played a part.

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<sup>1</sup> John B. Taylor, 'Housing and Monetary Policy' in *Housing, Housing Finance and Monetary Policy*, Federal Reserve Bank of Kansas City, 2008.

The pattern of global imbalances that resulted from this mix of policies has vexed policymakers for some time. We knew they were unsustainable and worried that the unwinding might be disorderly, though I don't think anyone could have guessed the course that events would actually take. But we did see that there were vulnerabilities present. However, nothing very much was done about these imbalances. Why was that?

In my view, it is a mistake to point the finger at any individual country's choice of policies. Given historical experience and the desire to facilitate rapid development, the Chinese strategy of export-led growth and high savings, facilitated by a weak renminbi, seems entirely rational. But that meant the rest of the world, and in particular the United States, needed to be willing to run a substantial current account deficit and capital account surplus if overall macroeconomic balance was to be maintained. Likewise, the Fed's desire to keep long-term interest rates low so as to counter the threat of deflation in the wake of the sharp slowdown in growth in the early years of this decade was understandable. But the net effect of these policies that were sensible from a national perspective was to generate an equilibrium for the world economy in which there was an ample supply of cheap funds looking for a suitable home. That home turned out to be mainly the housing market in a number of the advanced economies, particularly the United States as well as the United Kingdom.

A lesson from this episode is that the pursuit of rational policies from a national perspective need not result in a satisfactory overall equilibrium. Of course, it was precisely this realisation that drove Keynes' vision of the post-war economic order. With reform of the international financial institutions on the agenda once more, now is the time to start thinking again how we can better guide the choice and operation of national policy and regulatory frameworks so that they result in a coherent and sustainable outcome for the world as a whole, not just at the national level.

The IMF, for example, could usefully increase its focus on the mutual sustainability of national policy frameworks, analyse in more depth how policy actions within them interact internationally and identify those that are likely lead to unsatisfactory or

unsustainable global outcomes. Ideally, the international community ought then to be in a position to prevent the adoption of such frameworks, though I recognise that translating this into concrete action is a difficult task. One of the key challenges is that policy makers need to recognise that acting collectively will be in their own national interest. But then the same could have been said about the difficulty of promoting free trade and preventing protectionism before the foundation of the GATT/WTO. In any case, unless we grasp this nettle, the world economy may continue to be prone to the build-up of financial imbalances and their subsequent disorderly unwind. The G20 has an important role in taking this forward, with all of the right countries present around the table.

Let me now leave the global imbalances and policy externalities to one side and address a second issue: what role should monetary policy play in restraining an asset-price boom driven by excessive credit expansion? As I noted earlier, an abundance of liquidity was probably a contributory – though in my view not the primary – factor behind the decline in global real interest rates, the build-up of leverage in the financial system and the consequent asset-price boom. Yet this took place when central banks in the advanced economies were (fairly successfully) pursuing monetary policies in which price stability was a central objective, either as the primary objective as in the case of the European Central Bank and the Bank of England, or as part of a dual mandate in the case of the US Federal Reserve. Could we – and should we – have used monetary policy more actively to counter the build-up of credit and the associated increase in house and other asset prices?

One view, long advanced by Bill White and his colleagues at the Bank for International Settlements<sup>2</sup>, is that an exclusive focus on the stability of the prices of goods and services is conducive to a build-up of financial imbalances and associated asset price boom-busts. In the past, excessive credit growth tended to generate a pickup in inflation, necessitating a subsequent tightening in monetary policy, which in turn dampened both credit growth and inflation. But the success of inflation targeting and similar monetary frameworks in anchoring inflation expectations have flattened

the short-run Phillips curve trade-off and attenuated the inflationary impact of excessive credit growth, so lessening the pressure on the central bank to tighten policy. Moreover, in many of the advanced economies that experienced credit and housing booms, demand expansion was not unduly rapid: for instance, the average rate of growth of UK final domestic demand over the 2004-7 period was just 2¾%.

Now the unwinding of financial imbalances has often proved costly in the past in terms of lost output and increased unemployment. For instance, although there is a wide range of national experiences, Carmen Reinhart and Ken Rogoff<sup>3</sup> find that post-war financial crises in the advanced economies have, on average, been associated with a drop in real per capita growth of over two per cent and that it typically takes two years to return to trend; for the most catastrophic cases, the drop in growth was as much as five percentage points. Relatedly, the latest IMF *World Economic Outlook* contains analysis suggesting that downturns that are preceded by financial stress are on average associated with cumulative output losses about two percentage points higher than those that are not.

Given the potential costs of a bust, it would therefore appear to be wise to use monetary policy to try to prevent the build-up of the imbalances in the first place. Note that this is not going so far as to advocate targeting asset prices. That would place the burden of adjustment to real shocks – such as an improvement in productivity which should raise real equity prices, or an increase in population which should raise real house prices – on to the less flexible prices of goods and services rather than the highly flexible asset price. That cannot make sense. But it does at least justify ‘leaning against the wind’ during the upswing phase of a credit/asset-price boom in order to moderate the boom and thus also the prospective fallout from any subsequent bust. Steve Cecchetti and others<sup>4</sup> have advocated just such an approach.

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<sup>2</sup> See, for instance: William White ‘Is price stability enough?’, Bank for International Settlements Working Paper No 205, April 2006.

<sup>3</sup> Carmen Reinhart and Kenneth Rogoff, ‘Is the 2007 US Sub-Prime Financial Crisis So Different? An International Historical Comparison’, *American Economic Review*, May 2008, pp.339-344.

<sup>4</sup> See, for instance: Stephen Cecchetti, Hans Genberg and Sushil Wadhvani, ‘Asset Prices in a Flexible Inflation Targeting Framework’, in W. Hunter, G. Kaufman and M. Pomerleano, eds., *Asset Price*

Previously, I have argued<sup>5</sup> that a suitably flexible inflation targeting regime already provides the scope to take on board such concerns about the risks associated with excessive credit growth. For instance, the remit to the Bank of England's Monetary Policy Committee allows us to deviate from the inflation target in the near term, if by doing so it would enhance our chances of meeting it further out. A sharp contraction associated with the unwinding of a credit boom increases the likelihood of undershooting the target. So a near-term undershoot during the boom phase may, in principle, be warranted. Indeed, a central bank seeking to stabilize inflation over a sufficiently long time horizon should necessarily recognize the possible adverse long-term consequences of a credit-driven asset-price boom in its policy deliberations.

While the argument that central banks should factor in the long-term implications for output, and thus also inflation, of credit/asset-price boom-busts is persuasive, there are practical difficulties in pursuing a 'leaning against the wind' policy. These include the need to decide whether an asset price increase is warranted or whether it is based on misplaced expectations and poses a threat to future macroeconomic stability and the possibility that a rate increase might trigger exactly the bust one is worried about. But then central banks are called on to make difficult judgements all the time.

In my view, the most important qualification is simply that a modest increase in the official interest rate is unlikely to do much to restrain a credit/asset-price boom that is in full swing. It is simply not credible to believe that the UK house-price boom that is now unwinding would never have happened if only the Bank's Monetary Policy Committee had set official interest rates just a little bit higher. But an increase large enough to have had a material effect would have also depressed activity significantly. I doubt that people would be prepared to accept the clear short-term costs of such a strategy in return for the uncertain long-term benefits. Moreover, with low global real interest rates and abundant global liquidity, the effectiveness of monetary tightening by the Monetary Policy Committee alone in restraining credit growth would have

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*Bubbles: The Implications for Monetary, Regulatory and International Policies.* Cambridge, MA: MIT Press, 2002, pp.427-444.

<sup>5</sup> Charles Bean, 'Asset Prices, Financial Imbalances and Monetary Policy: Are Inflation Targets Enough?' in *Asset Prices and Monetary Policy*, eds. A.Richards and T. Robinson, Reserve Bank of Australia, Sydney, 2003.

been severely diluted. Co-ordinated action would have been necessary, which links back to my earlier theme.

The problem here is that the central bank is trying to achieve two objectives – price stability and the avoidance of unsustainable financial imbalances – with just one instrument, the official policy rate. So ideally one wants to call on another instrument, preferably one targeted at the market failure driving the excessive credit boom. Now confidence in the banking system is a public good, but the management and shareholders of banks do not have the incentive to internalise this fully. And the risk and potential cost of a harmful collapse increases as debt and leverage build up. The obvious way to address this problem is by requiring banks to raise extra buffers of capital or to put aside additional reserves during the boom phase of the credit cycle, which can then be called upon if the credit cycle turns.

The Spanish approach of dynamic provisioning represents a particular application of this general idea. There, banks are required to build up a general reserve equal to the difference between an estimate of long-term losses and specific provisions on currently impaired assets. But there are a variety of other ways one might go about setting up such a scheme. An alternative – or complementary – approach, due to Anil Kashyap, Jeremy Stein and Raghuram Rajan<sup>6</sup>, is to get banks to purchase private capital insurance from a suitable ‘deep pocket’, such as a sovereign wealth fund, that pays out if aggregate financial conditions deteriorate sufficiently.

In essence, the recent injection of additional capital into the banking systems of a number of countries, including in the United Kingdom, can be thought of as mimicking what would have happened with such a pro-cyclical capital requirement. Under such a regime, banks would have been required to raise extra capital during the boom phase, which would also have reduced the rate of credit expansion. Then during the bust phase, minimum capital requirements would be reduced, leaving the banks with a buffer of excess capital. That in turn would reduce the need for rapid de-

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<sup>6</sup> See Anil Kashyap, Jeremy Stein and Raghuram Rajan, ‘Rethinking Capital Regulation’, presented at Federal Reserve Bank of Kansas City Symposium on *Maintaining Stability in a Changing Financial System*, 2008.

leveraging and moderate any cut-back in lending. That is what the injection of extra capital is designed to achieve.

There is much work still to do on the design of such macro-prudential regulation. In particular, there is a range of bank-specific and macroeconomic indicators that could be used as the key and the right balance between automaticity and discretion in application needs to be struck. But it has the virtue of addressing the market failure directly, rather than indirectly through monetary policy. Had such a regime been in force over the past decade, I believe that it could have significantly eased our present troubles.

In conclusion, while lax global monetary policy probably played some part in the credit build-up that is now painfully unwinding, it was only one of many parents. And it is unrealistic to think that interest rates high enough to prevent that build-up would not also have had a major depressing effect on activity. I think the real lesson is that, alongside the many other regulatory improvements now under consideration, we need a regulatory regime that works against the natural cyclical excesses of the credit cycle. That would leave monetary policy free to be directed at where its comparative advantage lies, namely achieving overall price stability.